June 20, 2003

Mary L. Cottrell, Secretary
Department of Telecommunications and Energy
One South Station, Second Floor
Boston, Massachusetts 02110

Re: NSTAR Electric 2003 Energy Efficiency Plan; D.T.E. 03-48

Dear Secretary Cottrell:

Pursuant to 225 CMR 11.00, the Division of Energy Resources (DOER) is required to file a report with the Department of Telecommunications and Energy (DTE) as to the consistency of investor owned electric company energy efficiency plans with the energy efficiency goals of the Commonwealth. In addition, pursuant to G.L. c.25A, § 11G (inserted by the 1997 Electric Industry Restructuring Act), the Division is required to annually file a report with the DTE on proposed funding levels for investor-owned electric energy efficiency programs mandated by G.L. c.25, § 19. This letter constitutes the fulfillment of these regulatory and statutory obligations regarding the energy efficiency plan and budget proposed by the NSTAR Electric Company for the year 2003.

Authority:

Pursuant to the aforementioned authority, the DTE and the DOER share responsibility for regulating investor-owned electric energy efficiency programs. With respect to the Division's responsibilities the Act directs the DOER to oversee and coordinate ratepayer-funded energy efficiency programs. Furthermore, the DOER is charged with achieving certain goals, including:

?? ensuring that energy efficiency funds are allocated equitably among customer classes;
?? ensuring that there will be adequate support for "lost opportunity" efficiency programs in areas such as new construction, remodeling, and replacement of worn-out equipment;
?? giving due emphasis to statewide market transformation programs in order to systematically eliminate market barriers to energy efficiency goods and services; and
?? providing weatherization and efficiency services to low-income customers.

In addition, the DOER shall annually file a report with the DTE on the proposed funding levels for energy efficiency programs.

Process:

During 1999, the DOER developed a set of statewide energy efficiency goals and objectives to guide its oversight of Massachusetts' electric ratepayer-funded energy efficiency activities. These goals and objectives were developed in consultation with industry and consumer stakeholders. The goals and objectives provide guidance to energy efficiency Program Administrators in designing their programs, and enable the DOER to review proposed energy efficiency plans for consistency with those goals and objectives. Furthermore, the DOER uses the goals to measure whether ratepayer funded programs are achieving the desired impact.

The statewide energy efficiency goals largely came from key provisions of the Restructuring Act. In addition, these statements of direction and intent benefited from extensive public comment through a series of DOER-sponsored stakeholder workshops held over a period of six months in 1999. DTE staff was involved in this process. These goals and objectives are consistent with general policy principles developed in DTE's 96-100 energy efficiency plan guidelines and subsequent settlement agreements with distribution companies on their energy efficiency plans.

For the last several months the DOER's energy efficiency staff has been working with the company and other non-utility parties in translating the statewide energy efficiency goals into program designs and budgets for the period 2003. The process of working directly with the company and other parties has enabled DOER to ensure that the purposes of the legislatively mandated goals were being addressed as NSTAR Electric Company developed its 2003 energy efficiency plan.

Amendments to the 2003 Plan that were submitted June 5, 2003:

In its energy efficiency plan submitted to the DTE on April 30, 2003, the Company stated that performance metrics would be submitted as an amended Appendix D once these metrics were completed. These metrics, which are the measure by which the company earns some of its performance incentives, were jointly developed by all of the four electric company Program Administrators and interested non-utility parties. The performance metrics have been completed and the Company submitted them to the DOER and the DTE on June 5, 2003.

In addition, subsequent to the submission of the energy efficiency plan to the DTE and the DOER, the Company submitted a corrected copy of Table 3, *Summary of Out-Sourced Services in*, and in Table 1, *Available Performance Incentive Dollars* of Appendix D. NSTAR Electric submitted these Tables to the DOER and the DTE on June 5, 2003.

Findings:

The DOER has reviewed the NSTAR Electric Company energy efficiency plan for year 2003, including the amendments submitted to the DOER and the DTE June 5, 2003. The Division finds that the Company's energy efficiency plan, as amended, is consistent with the statewide energy efficiency goals. NSTAR Electric Company has proposed a plan (as described in the attached plan in chapters II, III, IV, V and VI) and a budget (as detailed in Tables 1, 2, 3 and 4) for the low income, residential, and commercial/industrial customers that adequately addresses the state's energy efficiency goals.

Therefore, the Division of Energy Resources approves the plan, including the proposed budget, for consistency with the energy efficiency goals of the Commonwealth.

Performance Incentive for 2003:

DOER has these additional specific comments regarding the Company's proposed performance incentive for 2003.

Background:

Chapter 25A, § 19, as updated by c.45 of the Acts of 2002, mandates that investor owned electric companies in Massachusetts shall provide energy efficiency programs to its customers. To motivate these companies to deliver the highest quality programs intended by the Legislature, the Department allows Program Administrators to earn a performance incentive that is meaningful from the companies' perspective but does not detract significantly from program resources meant to be invested in energy efficiency measures for customers.

Prior to DTE 98-100 each utility's performance incentive was the result of periodic (typically annual) settlement negotiations among the parties participating in that utility's energy collaborative, subject to DTE approval. The result was that the performance incentives of the several electric companies were developed independently from one another and without any explicit guidance from either the Legislature or the DTE. To bring a more uniform approach to this matter, parties presented several proposals on this topic to the Department during the DTE 98-100 proceedings. In its Order in this docket, the DTE adopted the DOER's proposal that the three-month

Treasury bill (3MT-Bill) be used as the index for the performance incentive. The DOER had argued that this index represented an approximation of the market valuation of an appropriate level of return on low-risk investments for the energy efficiency administrators. At the time of the DTE proceeding, the DOER estimated that the 3MT-Bill typically averaged between 4 and 6%, an adequate level of return to motivate the companies to deliver high quality energy efficiency services.

In late 2001 the 3MT-Bill dropped precipitously due to the volatility of the market. From April to December 2001, the 3MT-Bill rate fell from 3.97 % to 1.72%, and then hovered at around 1.7% through September 2002. By December 2002, the yield on 3MT dropped to 1.21%. The DOER believes that the 3MT-Bill has fallen to a level that no longer adequately motivates the energy efficiency administrators and consequently threatens the Legislature's intent to provide high quality energy efficiency programs to ratepayers.

Section 5 of the Department's 98-100 Guidelines sets forth the general method by which the distribution companies should calculate performance incentives. In brief, the Guidelines state that a distribution company which meets at least 75% of its performance goals may earn an after-tax performance incentive equal to the product of (1) the average yield of the three-month United States Treasury bills issued in the most recent twelve months, (2) total program implementation costs as included in the distribution company's energy efficiency plan, and (3) the level of performance actually achieved (capped at 125%).

Proposal for 2003:

As a result of extensive discussions among the Program Administrators, other stakeholders, and the DOER, an incentive structure for each distribution company to use for 2003 has been developed. The following is a description of the elements of the proposal which require Department approval and sets forth why the DOER believes that this proposal will better encourage the distribution companies to achieve DSM results.

DOER recommends that for the program year 2003, the incentive calculation for NSTAR Electric Company set forth in Section 5 of the Guidelines be revised to 1) substitute 5.00% for the average yield of the three-month United States Treasury bills issued in the most recent twelve months; and 2) lower the upper bound of the incentive level (exemplary level) to 110% of performance goals. Also for 2003, the DOER recommends that NSTAR Electric Company be able to earn performance incentives once they reach 70% of performance goals.

At the core of the new incentive structure is a more direct alignment of the Program Administrators' goals for energy efficiency with those of the ratepayers as reflected in those elements of the Department's rulings in D.T.E. 98-100. The restructured performance incentive also reflects more recent attention by the stakeholders and others in the region on demand-reduction efforts in addition to energy-reduction efforts; and by the on-going obligation to support the state's energy efficiency operational and programmatic goals. Performance goals will include a range of benefits which arise from energy efficiency: kWh, the standard focus of efficiency programs; kW, a more recent focus of attention; non-electric benefits; and performance metrics which target specific program activities or objectives.

The specific modifications to the Department's Guidelines, discussed below, reflect a desire by stakeholders to provide meaningful yet reasonable incentives to the Program Administrators to continue to manage the energy efficiency funds in a responsible and responsive manner; to acknowledge the experience that all the administrators have gained in implementing and managing the programs over the past years; and to recognize the number of energy efficiency-related changes that the administrators are expected to make in support of the continuing transition to a more uniform set of planning methods, evaluation and reporting activities, and performance incentives.

Discussion of Recommended Changes:

1. *Eliminating Volatility and Setting the Incentive Rate for 2003*

The DOER recommends that the incentive rate for 2003 be set at an after tax rate of 5.00 percent for Design level program performance – that is, for performance that meets performance goals. During the D.T.E. 98-100 proceedings leading to the development of the Guidelines, the DOER supported the use of the 3-month United States Treasury bill (T-bill) as the basis upon which to compute the performance incentive rate, noting that the rate was expected to vary between 4% and 6%. The experience of the past five years, however, has been quite different. While the rate remained somewhat stable in the 5 percent range through 1999, there has been considerable rate volatility from year to year, as well as a dramatic downward trend in the rate. In 2002, for example, the rate fluctuated from a high of 1.83% in March to a low of 1.21% in December with the average rate of 1.63% in 2002. The published yield on T-bills in both January and February 2003 is only 1.19%. The average yield on T-bills for the 12-month period March 2002 through February 2003 is only 1.55%. Both the downward direction of the T-bill rate and the continual variability in the rate have been detracting factors for the distribution companies to support the numerous aspects of the design and delivery of energy efficiency programs. Neither the state's energy efficiency goals nor the interests of utility customers are well served by this outcome.

The actual T-bill rate over the past several years has left the Program Administrators with little opportunity to be adequately compensated with reasonable incentives for their management of the energy efficiency funds. As previously noted, and citing similar reasons, last fall each distribution company requested that the Department approve a 4.25 percent rate (after tax) for use during 2002. The Department approved this rate for NSTAR Electric Company in D.T.E. 00-63-A on January 28, 2003. In that order, the Department reaffirmed that an incentive must be large enough to promote good program management, and noted that the 4.25% percent target was near the low end of the range that the DOER deemed sufficient to induce electric companies to manage programs well during the D.T.E. 98-100 proceedings (D.T.E. 00-63-A, p. 8). With the current and expected increased activities that the Program Administrators are being asked to conduct to make the programs even more effective than they are now, the DOER believes that it is appropriate to set the rate for 2003 at an after tax rate of 5.00 percent. This is the midpoint of the range of T-bill rates anticipated by the DOER during the D.T.E. 98-100 proceedings.

2. Lowering the Exemplary Level to 110 Percent of Design Level for 2003-2007:

The DOER recommends that the DTE lower the upper bound of the incentive level (exemplary level) to 110% of Design level performance goals. The Guidelines specify 125% as the upper bound. Over the past five years, and growing from the energy efficiency program experiences before restructuring, both the efficiency programs and the ability to establish credible post-program impact evaluation results have developed a level of maturity such that the understanding and certainty of how the programs perform over time has dramatically improved. This tends to mitigate the need to maintain such a wide range above the Design level incentive. In addition, the proposed change would lessen some distortions in the planning process caused by the 125% exemplary level. Lowering the exemplary level reduces the exposure to ratepayers for performance incentive payments to the Program Administrators by nearly 1.25 percent of total program expenses, potentially making those funds available for expenditure on customer efficiency program activities. This change, coupled with the proposed 5% after-tax Design level incentive rate, provides Program Administrators with a meaningful performance-based incentive that does not detract significantly from program resources meant to be invested in energy efficiency measures for customers.

3. Lowering the Threshold Level to 70 Percent of Design Level for 2003:

In order to support the transition to the new performance incentive structure, with its several newer components, the DOER recommends that the threshold level should be lowered to 70% of Design level performance goals for 2003. The lower level for the first year of implementation will encourage NSTAR Electric Company to take the necessary risks to fully address the changes required. In the past, the Company has rarely performed below the 70% level; thus ratepayers will not be at much risk of rewarding this lowered level of threshold performance.

Section 1(2) of the Department's Guidelines enables Program Administrators to request alternative methods for use in reviewing energy efficiency programs. The DOER believes that the circumstances associated with these three proposed changes to the Guidelines are sufficiently compelling that the requested modifications are justified.

Consistent with these facts, the DOER recommends that the Department modify its performance incentive for 2003 with respect to NSTAR Electric Company according to the three changes described above. DOER believes this is a performance incentive rate that will motivate NSTAR Electric Company to pursue the highest quality programs for ratepayers envisioned by the Legislature. This level of performance incentive is consistent with the rate of return the Division supported in DTE 98-100.

The Division is available to address any questions that the Department has regarding the DOER's findings with respect to the year 2003 NSTAR Electric Company energy efficiency plan and the associated performance incentive. Please let us know if you would like to discuss these matters.

Yours truly,

Steven I. Venezia
Deputy General Counsel

Service List